German Economic Team

UKRAINE

Development of FDI in 2020 and impact of the new statistical methodology

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Structure

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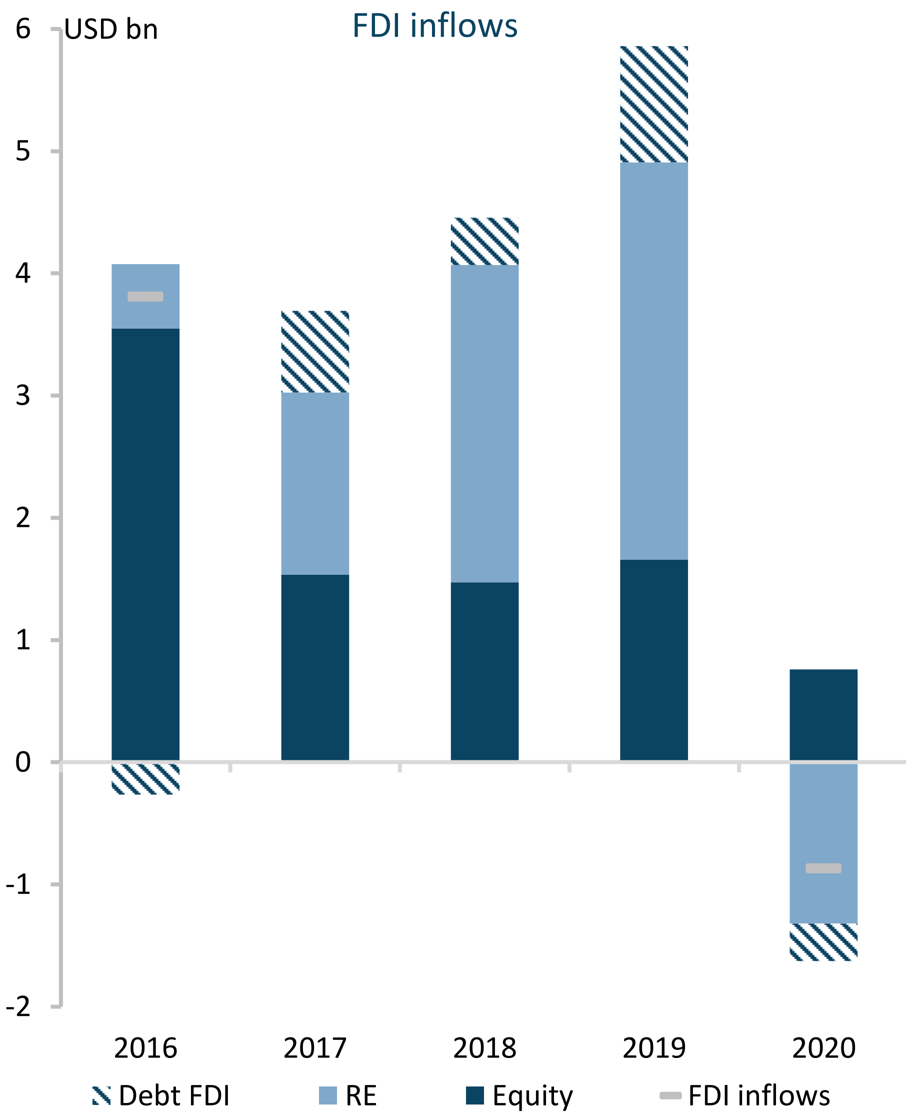
1. Introduction

- How did Foreign Direct Investment (FDI) to Ukraine behave during the COVID-19 pandemic?
- During a global economic crisis, sharp reductions in inflows and losses in FDI companies are to be expected
- Also, the statistical methodology for FDI was updated by the NBU in 2020, now including reinvestment of earnings (RE) of FDI companies as FDI inflows
- Long-term development of FDI stock in Ukraine between 2009 and 2019 was analysed in GET PB/01/2020

This Policy Briefing

- Analysis of effect of pandemic on FDI inflows
- Analysis of development of FDI stock 2016 to 2020
- Explanation and analysis of impact of new statistical methodology
- Focus on inward FDI (foreign capital invested in Ukraine)

2. Development of FDI inflows



*Source: NBU, *2020 data for RE are preliminary*

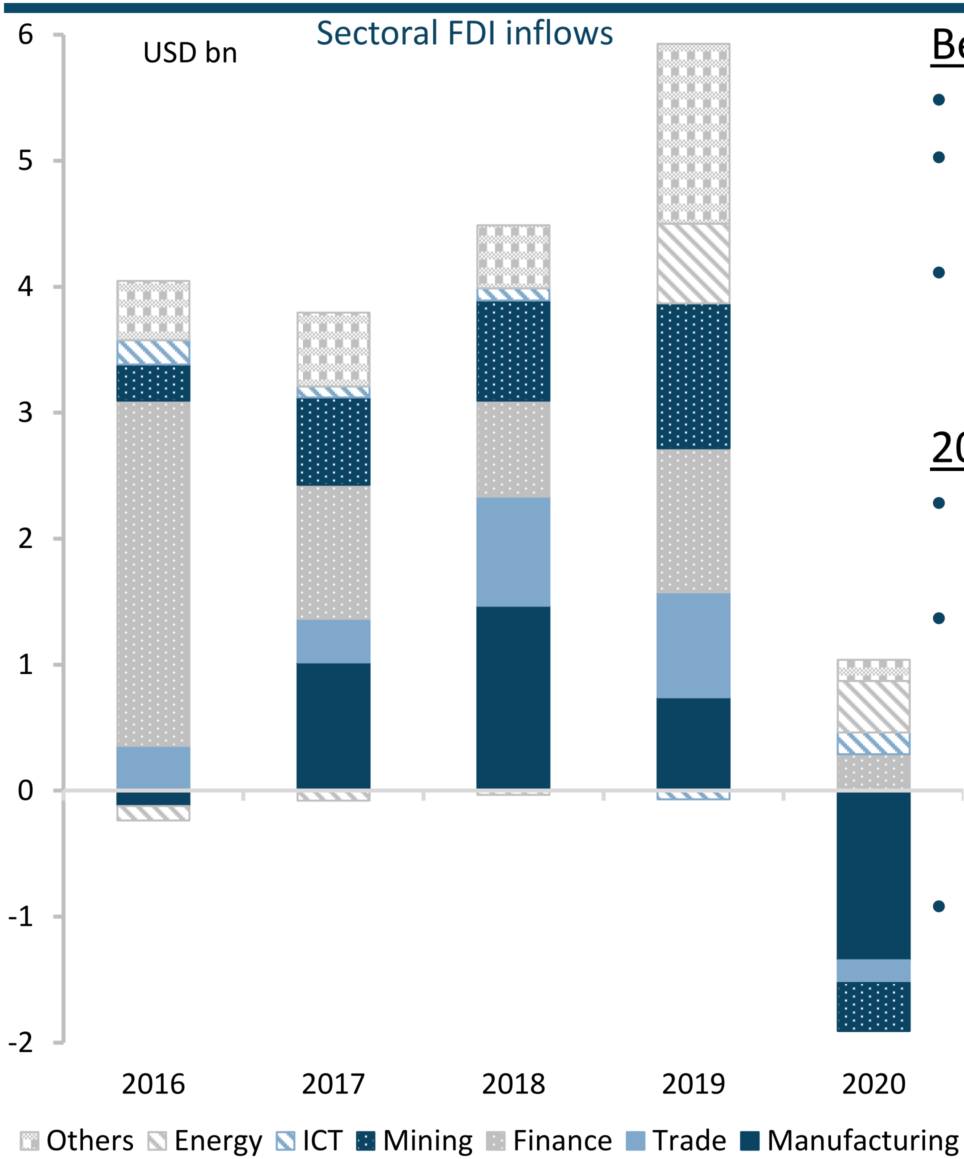
<u>Before 2020:</u>

- Stable FDI inflows between USD 3.7 and 5.9 bn (3% to 4% of GDP)
- Reinvestment of earnings (RE) accounted for increasing share, 55% of total inflows 2019
- This reflects stable economic development and profitability of companies until 2019
- Relatively constant inflows of other “new” equity FDI

<u>2020:</u>

- Negative RE drives a net outflow of FDI by USD 0.9 bn (-0.6% of GDP)
- Negative RE (- USD 1.3 bn) reflects uncompensated losses of companies, not actual capital outflows
- Positive equity FDI inflows of USD 0.8 bn despite pandemic

Development of FDI inflows by sectors



*Source: NBU, *2020 data are preliminary*

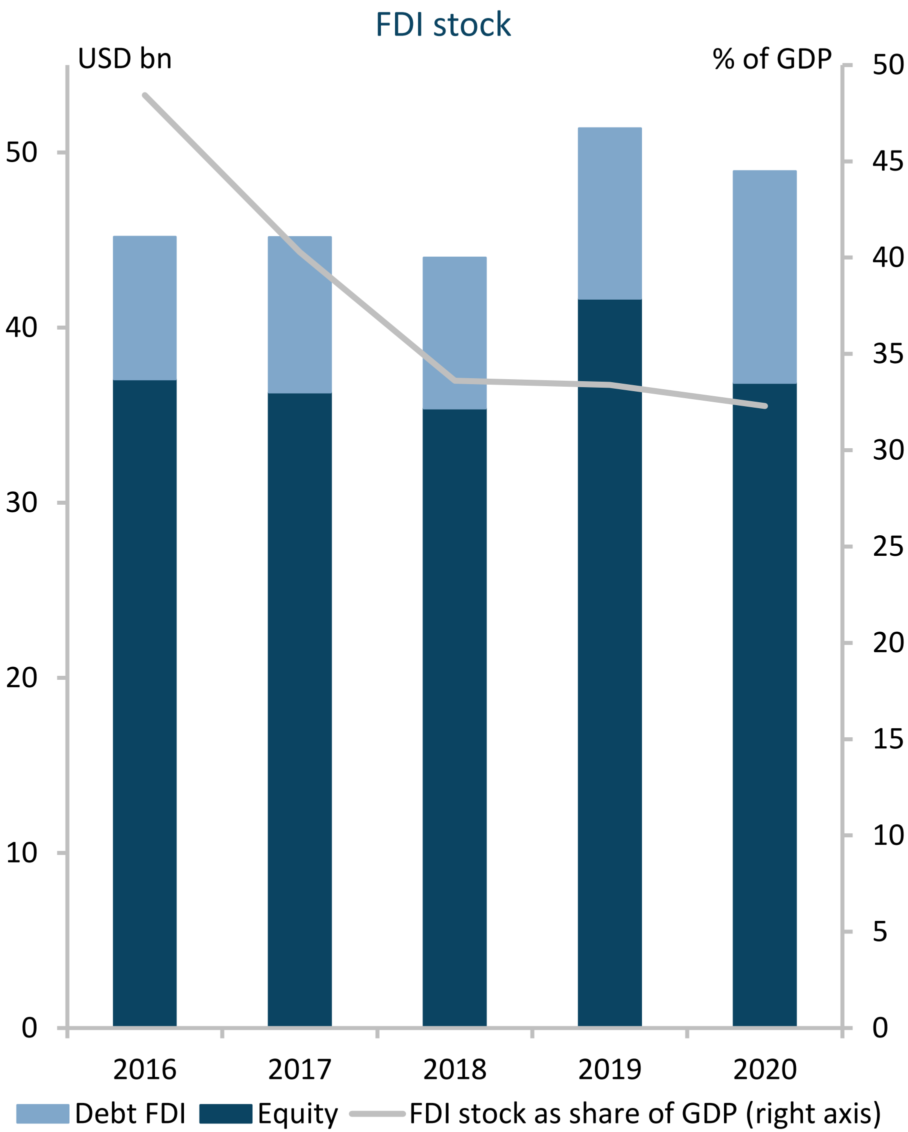
<u>Before 2020</u>

- Diversified inflows across sectors
- Manufacturing, mining and finance were most important sectors
- Increasing role of FDI in energy sector (e.g. renewables) in 2019

<u>2020:</u>

- Negative inflows mainly due to negative RE caused by company losses
- Manufacturing and mining most affected
  – Large FDI concentrations in sectors
  – Heavy effect of pandemic e.g. through commodity markets and suspension of EU car production
- Positive inflows to finance, ICT, energy (role of projects pipeline)

3. Development of FDI stock

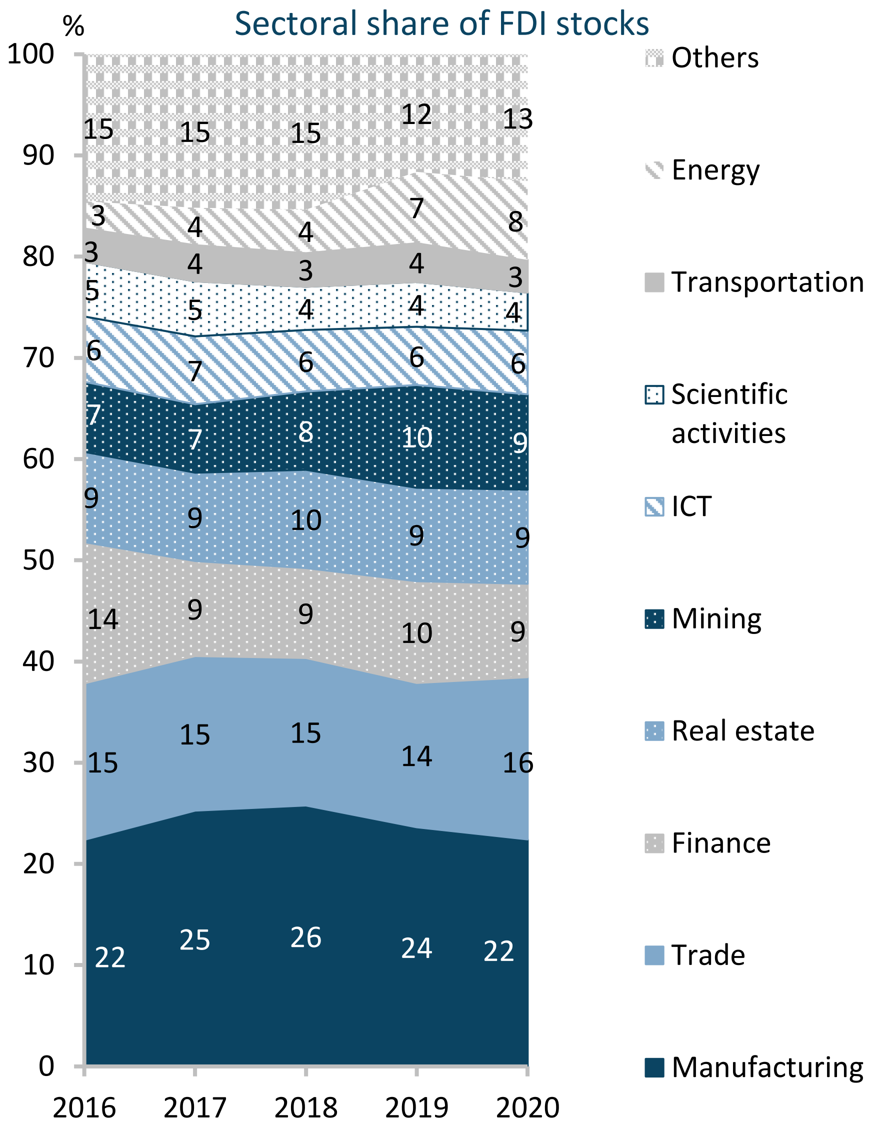


*Source: NBU, *2020 data are preliminary*

- FDI stock constant between 2016 and 2018 and strongly increased in 2019
- FDI stock declined in 2020 but remained above the level of 2018
- Growth of FDI stock was lower than nominal GDP growth, thus share of GDP declined from 48% (2016) to 32% (2020)

➢ Thus, declining share of foreign drivers and increasing share of domestic drivers of economy activity

Shares of destination sectors

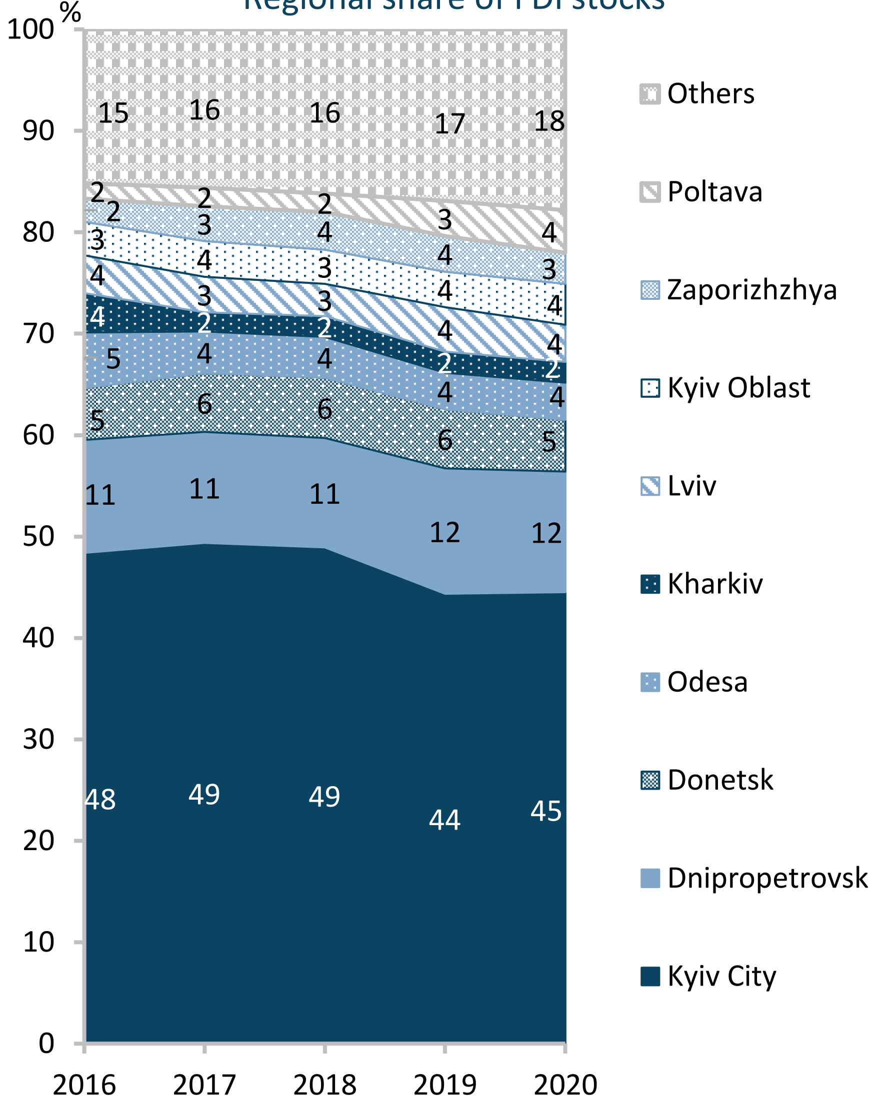


- Manufacturing, trade and finance account for half of FDI stock
- Energy sector share increased strongly from 3% (2016) to 8% (2020)
- Financial sector share has declined from 14% (2016) to 9% (2020)
- Pandemic did not substantially alter the pattern of change

*Source: NBU, own calculation, *data for 2020 are preliminary*

Shares of destination regions

Regional share of FDI stocks



Source: NBU, own calculation, *data for 2020 are preliminary, others include undistributed by regions

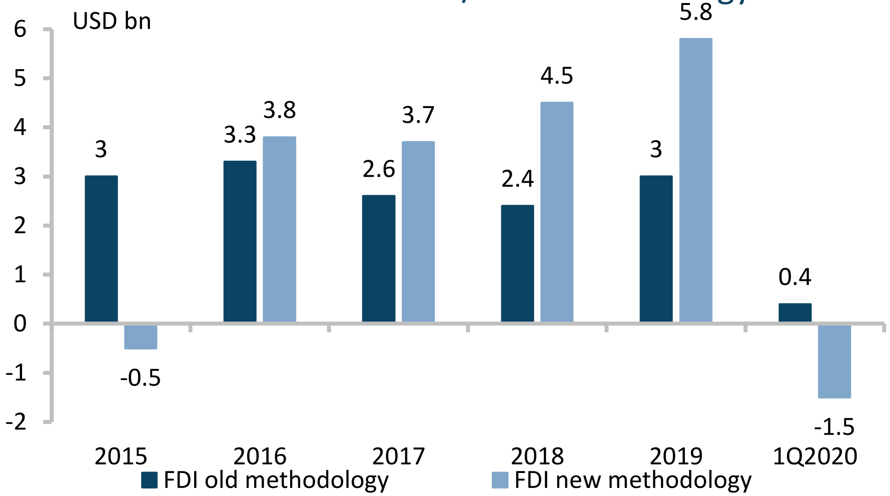
- Kyiv City and Dnipropetrovsk still account for more than half of FDI stock
- Overall, share of oblasts with lower shares of total FDI is increasing:
  - Poltava: from 1.5% to 4.2%
  - Other oblasts: from 15.2% to 17.8%

4. Change in statistical methodology

- Since June 2020, the National Bank of Ukraine (NBU) became solely responsible for FDI statistics. At the same time, the FDI calculation methodology was updated in accordance with the sixth edition of the IMF Balance of Payments Manual (BPM6)
- Methodology for calculating FDI stock
  - See Technical Note 02/2020 for detailed explanation
  - Current value now calculated based on equity rather than statutory capital of companies
  - Now a better measure of the current value of the investment
  - New methodology was already used for financial companies
- Accounting for FDI flows in balance of payments
  - Main issue: Reinvested earnings now increase FDI stock (higher equity) and are also considered as an FDI inflow
  - Current account: Reinvested earnings recorded as outflow under “investment income” (as if earnings had first been paid out to investors)
  - Financial account: Reinvested earnings booked as a liability under “direct investment” (foreign ownership in the economy increased)
  - ➢ RE do not reflect actual cross-border money transactions. Profits accruing to foreign investors have been converted into more foreign ownership of assets in Ukraine

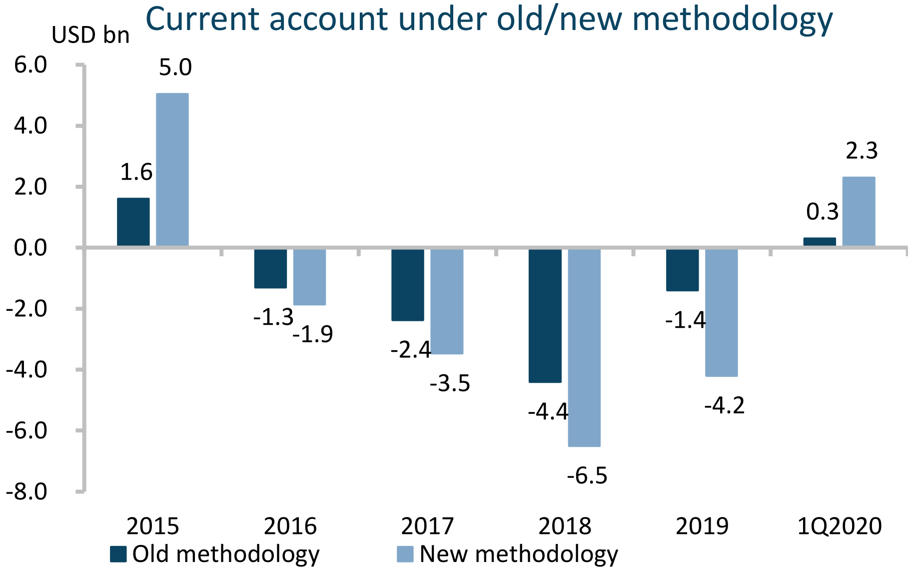
Impact on balance of payment statistics

FDI after old/new methodology



Source: NBU report, 2020, old methodology data only available until 1Q2020

Current account under old/new methodology



Source: NBU report, 2020, old methodology data only available until 1Q2020

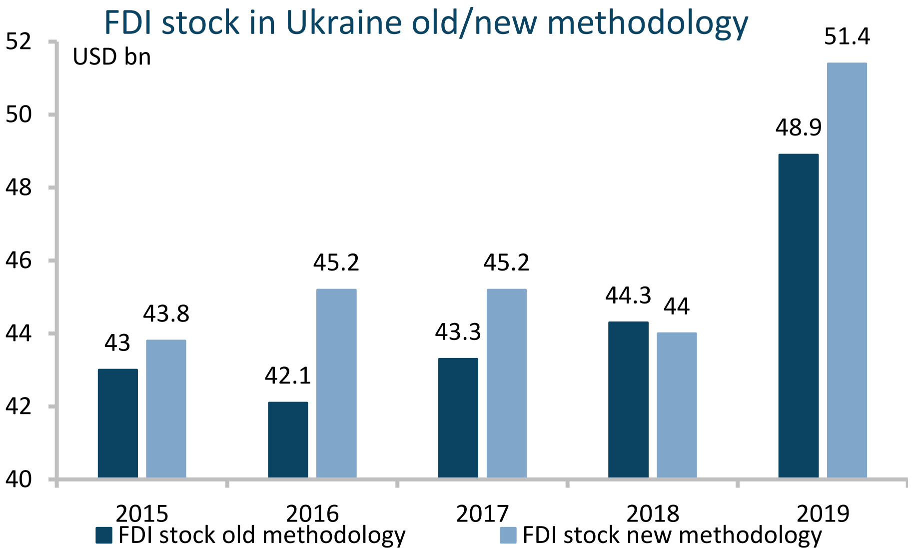
Impact on FDI inflow statistics

- Inclusion of all reinvested earnings leads to higher FDI inflows during years with solid economic growth (e.g. 2019)
- In crisis years, losses not compensated by capital injections from owners lead to negative RE and hence negative FDI inflows

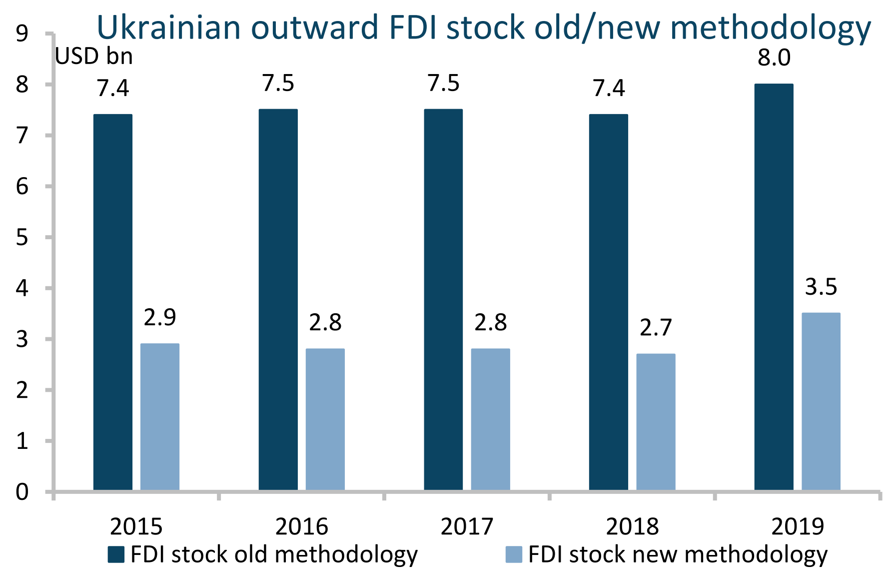
Impact on current account (CA) statistics

- Retained earnings/uncompensated losses are treated as FDI out/inflows
- Problematic for CA interpretation: high CA deficits usually perceived as external risk
- But in case of RE, no money flows crossed borders and CA flows are automatically balanced with financial account liabilities
- ➢ Definition change limits power of CA as a proxy for external vulnerability of economy
- ➢ CA deficit in 2019 was higher by 1.8% of GDP due to methodology change

Impact on FDI stock statistics



Source: NBU report, 2020



Source: NBU report, 2020

- Change in methodology for value of FDI companies without stock market capitalisation
  - Previously: based on statutory capital of companies (only rarely changes)
  - Now: based on equity, a measure of the actual capital of companies including reserves and undistributed profits
- Impact on FDI stock in Ukraine:
  - 33.3% instead of 31.8% of GDP in 2019
  - Higher volatility of FDI stock
  - Now a better measure of current value of companies and FDI stock
- Impact on outward FDI stock (Ukrainian capital invested abroad):
  - USD 8.0 bn vs 3.5 bn in 2019
  - Now based on UAH book values, not at historic FX values

5. Conclusion

Developments in 2020

- Pandemic mainly affects FDI inflows due to losses of companies
- No actual net outflows of capital took place and investment of new equity FDI remained positive in 2020
- Patterns of FDI did not change substantially in 2020

Methodological change

- FDI stock statistics now more accurately measure the value of FDI
- Difficulties for current account interpretation and FDI flow interpretation as reinvested earnings do not correspond to cross-border money transactions
- New methodology increases volatility of both current account and FDI inflows: E.g. higher current account surplus in 2020 due to negative RE /company losses

About the German Economic Team

German Economic Team

Financed by the Federal Ministry for Economic Affairs and Energy, the German Economic Team (GET) advises the governments of Moldova, Georgia, Ukraine, Belarus and Uzbekistan on economic policy matters. Furthermore, GET covers specific topics in other countries, such as Armenia. Berlin Economics has been commissioned with the implementation of the consultancy.

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Annex: Balance of Payments 2019 (old/new methodology)

Balance of payments of Ukraine, USD m

	2019 before revision	2019 after revision	Difference
A.Current account	-1,392	-4,208	-2,816
3. Primary income	4,701	1,885	-2,816
3.1 Compensation of employees	12,754	12,754	0
3.2. Investment income	-8,053	-10,869	-2,816
3.2.3. Reinvested earnings	**-434**	**-3,250**	**-2,816**
C. Financial account	-7,334	-10,150	-2,816
6. Direct investment	-2,396	-5,212	-2,816
6.1 Net incurrence of liabilities	3,017	5,833	2,816
6.1.3. Reinvestment of earnings	**434**	**3,250**	**2,816**
Overall balance	5,980	5,980	0

Source: NBU Report 2020, balance of payments statistics, Nummeration based on EU-Commission Regulation 555/2012

- Reinvested earnings (RE) of non-financial companies added in current and financial accounts
- RE of financial companies already was included before
- Backward revision of BoP statistics until 2015

- 2019: New methodology affected balance of payments by USD 2.8 bn (1.8% of GDP)
  - Current account deficit increased: RE treated as income of foreign investors
  - Conversely, the financial account deficit decreased by the same figure
  - In background, FDI stock increased due to RE

➢ Due to new methodology, positive reinvested earnings increase current account deficit without actual cash outflows taking place